

CEPS COMMENTARY

*Thinking ahead for Europe*

Why the regulatory witch-hunt for 'closet trackers' is a dead-end

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The active vs passive investment debate has taken a new turn recently, with reports that the European watchdog of securities markets – the European Securities and Markets Authority or ESMA – is to take a closer look at so-called 'closet trackers', with a view to identifying whether there is a potential need for a coordinated pan-European policy response. 'Closet trackers' is a term used to describe fund managers who charge considerably higher fees than passive managers, owing to their seemingly being 'actively managed' in a bid to generate 'alpha', yet who achieve comparable results to passively managed funds by using effectively the same, low turnover investment strategy. 'Alpha' is a term used among financial markets participants to explain the ability of a fund manager to outperform a benchmark index through active stock selection. Investors are usually prepared to pay higher fees to skilled fund managers who are able to consistently beat market indices on a risk-adjusted basis and/or net of fees. To the extent that many fund managers are not able to do so consistently suggests that passive investing via exchange-traded funds (ETFs) ought to occupy a greater share of investment portfolios than is currently the case. Passive investing vehicles such as ETFs are considerably cheaper and typically display total expense ratios (TERs) between one-half to one-fifth of the cost of their actively managed counterparts.

The catalyst for this regulatory development appears to be the outcome of a recent survey of asset managers conducted by the Danish financial services authority. The survey suggests that many actively managed funds in the Danish market are closet trackers, who charge high fees compared to ETFs but deliver little alpha, as they too closely replicate their benchmark indices. Consumer protection advocates, such as the Financial Services Consumer Panel and Better Finance have echoed similar concerns. Whilst the role of consumer advocates in the realm of financial markets policy is very welcome – indeed, consumer rights advocates still suffer from under-representation at European level – they appear to be leading regulators astray in this particular case.

This is not to say that the price of financial services and products should not be an issue of regulatory concern. The cost of various investment vehicles, when not carefully managed, can over time significantly erode the net returns available to investors. Thus, focusing on the relative costs of different investment products is not misguided, particularly against a backdrop of an accelerating transition from defined benefit to defined contribution, an ageing

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population, and the increasingly important role that private asset management will play in marshalling savings into long-term investments.

Yet the path to a balanced regulatory intervention in this space is fraught with dangers, and could potentially do more harm than good, including from a consumer's perspective. Two of these difficulties are particularly salient and immediately obvious.

1) How to define a closet tracker?

The first difficulty is arriving at an acceptable definition of a closet tracker. Any regulatory intervention in this space is meritless unless the phenomenon is clearly defined. A definition itself is not sufficient as a starting point to consider regulatory intervention. Such a definition ought to be dynamically consistent, i.e. it must be flexible enough to cater to the vagaries of markets and investment decisions made by active managers, and it must serve as a reliable gauge over time to determine which managers are engaging in undesirable practices. Yet defining what constitutes a 'closet index', whilst appearing easy in theory, becomes far more difficult in practice.

Consider first how regulators could go about establishing such a definition, and the questions they would need to answer:

- Is a closet tracker one that mimics a benchmark index "too much" in terms of its composition and weightings?
- Is it one that replicates the performance of an index "too closely" – even though their compositions may differ – i.e. one whose tracking error to the index is deemed "too little"?
- Is it one whose turnover is deemed "too low", either on an absolute level, or relative to its benchmark?
- Or is it all, or some, of the above?

Further, but equally important questions include:

- Are these thresholds subject to some kind of minimum time horizon, meaning that a closet tracker is one that only marginally deviates from its benchmark over a prolonged period of time? (try to define "prolonged")
- What materiality threshold would be applicable in any, or all, of these cases, i.e. how would "too little", "too low" or "too much" be defined?

Clearly, arriving at a quantitative definition of closet tracking means thresholds would have to be established around turnover ratios, portfolio composition and tracking error, to name but a few of the possible metrics that regulators would have to consider. Arriving at those thresholds in a non-arbitrary fashion would be exceptionally difficult, and would likely vary by investment strategy, meaning a very complex set of rules, which may well impact on portfolio managers' behaviour in unpredictable ways. And yet rules on closet tracking that do not quantitatively define the practice would either have no bite or would give regulators far too much discretion. The latter would increase regulatory uncertainty and stifle product development.

Regulatory arbitrage would inevitably ensue from a formal regulatory classification of a fund as a closet tracker or not. As regulatory principles are less prone to such arbitrage than detailed rules, they occasionally lead to better outcomes. They accordingly ought not to be forgotten in this debate.

2) Are we moving towards price regulation in asset management?

The second major difficulty is how regulators would establish what constitutes a 'fair price' with respect to passive investing. That is, in a way, the crux of the problem. If it weren't for the higher active management fees that closet trackers charge, nobody would be fussing over them. So the key regulatory question in this case – although many observers may be unaware of it – is: What is the 'fair price' of a passive investment?

That formal regulatory intervention is even being considered in relation to the *levels* of fees charged by financial services providers is worrying. As an opinion on what the price of a passive investment ought to be, the apparent witch hunt for closet trackers amounts to nothing other than price regulation, for the simple reason that it suggests there ought to be a ceiling on the prices that investors should pay for passive investment strategies. If it were to be implemented in this fashion, such regulatory intervention would have nothing to do with regulating for transparency, consistency, or comparability of prices. It also raises difficult questions about how a fair price for a passive investment would be arrived at by the regulator. Even *within* the passive investing space, prices charged by providers vary markedly, and depend not just on competition, but on investment strategy, product structuring, distribution, scale, regulation and a host of other factors.

Couched in these terms, the proposed intervention would likely be received less well by some of its proponents among the passive investing community. The assumption that regulators are better positioned than the competitive forces of the market to determine the fair price of a service or an investment strategy is questionable.

3) Is a regulatory intervention really warranted?

Regulators ought not to fall into the clever lobbying traps set by the passive industry to increase their market share – in what is already rapidly becoming an oligopoly, or even a duopoly. In order to remain impartial, it would be dishonest to suggest that passive investing is anything other than an absolutely critical part of the financial ecosystem. The passive investing industry is unambiguously one of the great and positive financial innovations of the past half century. It responds cheaply and effectively to the demands of a huge range of institutional and private investors.

But active investing is also a critical part of the financial ecosystem, including some investment strategies, which may come under the fold of still-loose definitions of closet tracking. As just one example, closet trackers might contribute to financial stability, as ETFs are more beholden to short-term investor flows than actively managed funds. Rapid tactical shifts in and out of ETFs to benefit from market momentum, temporary tactical tilts in asset allocation, or for risk management purposes, can occasionally lead to more violent market gyrations – probably in large part because they are cheaper. In a bid to separate the wheat from the chaff, regulators and consumer rights advocates might inadvertently damage the fragile balance of the financial ecosystem. Greater financial market volatility and instability would be a high price to pay to shave a few tens of basis points off the annual cost of certain types of managed investment.

From a consumer-protection perspective, investment benchmarks are useful proxies of risk. Indeed, they are the pillars of consumer protection regimes such as MiFID and UCITS. The very purpose of an ex-ante regulatory requirement for a fund/investment manager to identify the benchmark to which he/she is managing the portfolio is to allow the investor to make an informed decision on the potential risk-return characteristics of the investment. To the extent that closet trackers are seemingly being encouraged to deviate more from their benchmarks, the usefulness of the benchmark as a gauge of risk becomes less relevant or meaningful – with potentially detrimental results for consumers.

Consider, for example, the case of a country index, which is populated with defensive stocks, such as utilities. Depending on market conditions, an active manager might take a conscious bet, with a bearish view, to hug the defensive benchmark rather than taking big bets on cyclical stocks within or outside the index. Such benchmark hugging, in particular cases, is anything but detrimental to investors. On the contrary, the ability of an active manager to hug a benchmark as a defensive strategy, whether occasionally or even over prolonged periods of time, might help preserve investors' capital.

The phenomenon identified by the Financial Services Consumer Panel of 'closet indexation' being more prevalent in the UK and Europe than in the United States might also be due, paradoxically, to regulation. A very significant portion of funds registered in the EU are UCITS, and to the extent that UCITS impose strict diversification requirements on investment managers, some closet trackers may be none other than UCITS-compliant funds, which are prevented, by regulation, from taking the kinds of more active, concentrated bets that enhance tracking error. The UCITS diversification requirements are indeed a protection for consumers, as larger potential drawdowns may derive from aggressively deviating from a benchmark through highly concentrated bets. Thus, some actively managed funds, including closet trackers, might in practice be much better diversified than some types of passive investments, for example, a passive tracker fund, which aims to replicate the *performance* of an index through financial wizardry such as complicated algorithms. This suggests that rather than pitting closet trackers against passive funds, the quality of product structuring is probably a more important consideration in the ongoing debate.

Finally, in addition to the aforementioned technical difficulties of defining what constitutes a closet tracker and of determining what constitutes a fair price to pay for a passive investment strategy, this potential regulatory intervention suggests that regulators are barking up the wrong tree: ESMA is far too sparsely resourced, and investor protection advocates ought to have far more pressing concerns, than to dedicate significant resources to a problem that pales in comparison to wider, unresolved, market structure and policy issues. Additionally, for the reasons articulated in this commentary, optimal policy design in this space would be exceptionally difficult, meaning that the risks are skewed towards a poorly designed intervention.

Regulation can lead to improved consumer outcomes, but only under certain conditions. These conditions are namely: i) it responds to a clear market failure; ii) it identifies and deploys the most appropriate/effective instrument to address the market failure; and iii) the response is proportionate to the failure and doesn't go beyond the minimum intervention required, so as not to destabilise the animal spirits of the free economy, particularly competitive forces conducive to creative destruction. It is not immediately apparent that a market failure exists in relation to closet trackers, nor that regulatory interventions of the kind suggested would lead to improved outcomes for consumers. The best regulatory tools to tackle this perceived problem are transparency and competition. These tools are already available to regulators through a range of product design, disclosure, suitability and conflicts of interest management embedded in EU legislative measures, particularly MiFID and UCITS, which form the core of investor protection in relation to the European asset management industry.

In the past, interventions made in the name of investor protection have occasionally led to worse outcomes for investors. And sometimes, just sometimes, the best course of policy action has been inaction. May this lesson not be lost during the exercise regulators are currently undertaking on closet trackers.